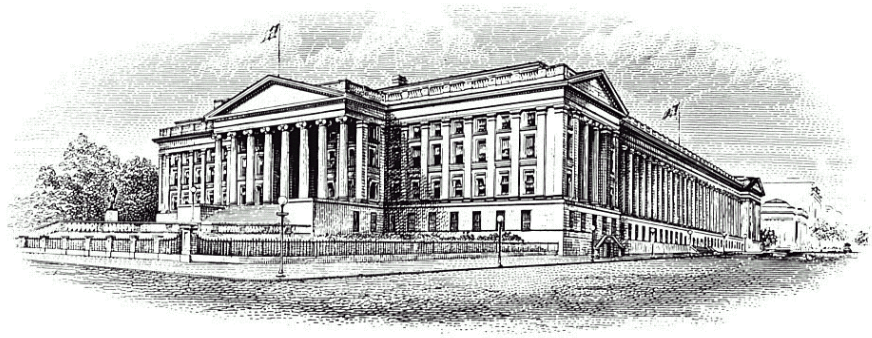

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Grants and Sovereign Debt Restructuring:
Two Key Elements of a Reform Agenda for the International Financial Institutions

Testimony of John B. Taylor
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Before the Joint Economic Committee

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Thank you Chairman Saxton, Vice-Chairman Reed, and other members of the Committee for inviting me to participate in this hearing on the international financial institutions. I know that reform of these institutions has been a high priority for this Committee. Indeed, many ideas coming out of the Committee's hearings—including calls for greater transparency and better accounting of costs—are already having a positive impact on these institutions.

Reform of the international financial institutions has also been a high priority of the Bush Administration. Our fundamental goals in this reform effort are to raise economic growth and improve economic stability in the world economy. The international financial institutions can help us achieve these goals, but there is room for improvement.

The Bush Administration—in a series of speeches by President Bush and Secretary O'Neill—has put forth a substantial reform agenda for the World Bank and the International Monetary Fund. In my written testimony today, I would like to discuss two key parts of that reform agenda —the use of grants rather than loans and the creation of an improved sovereign debt restructuring process. Both reforms are now a major focus of international discussion and negotiations.

Higher Economic Growth Through World Bank Grants

Clearly there is too much poverty in the world. We know that the key to reducing poverty is higher productivity growth. But productivity growth is far below its potential in many poor countries. We know that we can raise productivity growth by improving education and by increasing private investment. But educational achievement remains low as do private capital flows to developing countries and emerging markets in general.

So, in order to achieve our goals of raising standards of living around the world, the World Bank and other multilateral development banks must address the problems of productivity growth. That is why we have chosen productivity growth as a major theme of our reform effort. And to be sure that the actions taken actually increase productivity growth, we have emphasized the importance of measuring results of all actions taken, so we can see what works and what doesn't. Achieving measurable results and raising productivity growth are the rationales behind the proposal to shift from loans toward grants at the multilateral development banks.

Last summer in a speech at the World Bank, President Bush first put forth this grant proposal for the World Bank and the other multilateral development banks. And last month in a speech to the World Affairs Council at the Organization of American States, he forcefully reiterated that proposal. He "urged the World Bank to provide up to 50 percent of its assistance to the world's poorest nations in the form of grants rather than loans—grants for education, for health, for nutrition, for water supplies and for sanitation." Why is this grants proposal so important? Why is moving from loans to grants a major element of our reform effort? How does it relate to the theme of measurable results?

The Advantages of Grants

The part of the World Bank that provides assistance to the poorest countries is the International Development Association, or IDA. Funds for IDA are replenished at three-year intervals by the United States and other donor countries, and U.S. contributions to IDA must be appropriated each year by Congress. Virtually all of the IDA assistance to poor countries is now in the form of loans (these loans are sometimes called IDA credits). The terms on these loans are highly favorable to the borrowing country—far more favorable than the government of the country could obtain in private capital markets. The loans have a 40-year maturity; the interest rate (referred to a "service charge") is 0.75 percent; and there is a 10-year grace period.

Because the terms on these IDA loans are so favorable, they are really not loans in the everyday sense of the word. The total interest and principal that must be paid back is much less, in present value terms, than the amount loaned. For example, the present discounted value of all future payments on a $1,000,000 IDA loan at a 6 percent discount rate is only $337,671. Most developing countries, however, face interest rates much higher than this: if the discount rate were 15 percent, then the present discounted value would be only $97,569. Moreover, because the grace period is so long, a finance minister of a borrowing country could be out of office long before any principal has to be paid back on such a loan; and while in office there is only the small 75 basis point interest payment. It is misleading to call such assistance "lending." Such terminology is not consistent with basic goals of transparency in government. Thus, one reason that grants are better than IDA-type loans is simply that they are more straightforward and transparent.

Another reason to prefer grants to loans as a form of IDA assistance is that many of the countries now borrowing from IDA are part of the Heavily Indebted Poor Country (HIPC) initiative. HIPCs are poor countries that have unsustainable amounts of debt. As many have argued, by forgiving this debt the hope is that these countries can achieve a more sustainable debt situation. Through the HIPC initiative, the international financial institutions, in effect, write off their loans to these poor countries and relieve the countries' debt burden. However, at the same time we are writing off loans to these poor countries, by creating more loans from IDA—even at favorable terms—we are adding to their debt burden. This approach seems counter productive. Grants, on the other hand, are better than loans because they do not add to the debt burden of these countries.

Grants are particularly advantageous in cases where it is unrealistic to assume that the activity being supported will generate enough direct economic returns to pay back IDA loans. The use of grants thus removes a disincentive for governments to focus on the most disadvantaged people and sectors, e.g., rural poor, girls, indigenous people, and AIDs orphans. For example, issuing a loan rather than a grant for humanitarian assistance or major social crises—for instance, to provide assistance to HIV/AIDS patients—seems particularly inappropriate. That is why President Bush emphasized that grants should be used in certain social sectors—for "education, for health, for nutrition, for water supplies and for sanitation."

Yet another advantage of grants is that they can easily be tied to measurable performance or results. Some people think that the President's proposal is for "free" grants. That is certainly not the case; on the contrary, the grants are to be tied to specific performance. For example, if there is a grant for education, then the grant would not continue unless there are results—unless enrollment rises, for example. If the grant is designed to assist HIV/AIDS patients, for example, then the grant will continue as long as the assistance is being provided. If the assistance becomes inadequate, then the grant funds should go to another provider. Month by month, quarter by quarter, the group receiving the grant has to keep delivering the service or the grant stops.

International Differences and Negotiations

Since the President made the grants proposal last summer, we have been working and negotiating with other IDA donors to move from loans toward more grants. Of course, the World Bank is an international institution, so to implement any reform a coalition of support must be developed. A number of non-governmental organizations and developing countries have expressed strong support for the proposal, but for the proposal to be implemented it is necessary to garner the support of major donors to IDA. The current international negotiations are taking place in the context of the current three-year replenishment of IDA, which we hope to settle soon. An important and extensive discussion on this subject took place among the G-7 Finance Ministers and Central Bank Governors in Ottawa last weekend.

There is now widespread agreement among G-7 donor countries that a larger proportion of IDA assistance should be given in the form of grants, as the President proposed. However, there are still differences of opinion among donor countries about the details and ultimately about how much should go to grants. For example, the President called for 50 percent grant assistance for the "world's poorest nations." But exactly how poor countries should be before they qualify for this percentage of grants rather than loans is still an unsettled question.

The United States has shown flexibility in the negotiations, stating that it would be acceptable to provide 50 percent grant assistance to those countries with annual per capita incomes less than $365, that is, less than $1 per day. But some donor countries would like a more exclusive definition of "poor"; some would exclude those countries with annual per capita incomes above $250. Another difference of opinion is how to define the categories of assistance that would qualify for grants. Some donor countries would like to exclude education, in contrast to the President's proposal.

One of the more strongly voiced objections to increasing the proportion of grant assistance beyond a certain level is that it would reduce the "re-flows" to IDA. Re-flows are primarily the funds that are paid back into IDA by countries with IDA loans. These payments can then be lent again to poor countries. But, of course, poor countries themselves pay these re-flows. In other words, under the current IDA program the poor are supporting the poor. So reduced re-flows through the grants really means more support for poor countries.

Significant Increase in U.S. Support for IDA, Based On Results

Another objection to moving further toward grants is the argument that U.S. assistance to IDA will decline under a grants program. The facts say otherwise. Indeed, the United States is offering a significant increase in its contribution to IDA. The United States in the last six years has been bringing down its contributions to IDA in real terms. The President intends to reverse this trend. He proposes to increase our contributions to IDA, as long as the contributions result in better performance. In the budget he submitted to Congress last week, he is proposing that the U.S. IDA contribution increase—from previous years' annual total of $803 million—to $850 million in the first year, to $950 million the second year, and to $1,050 million in the third year. These step-ups will only occur if there is an improvement in performance at the World Bank, but they would bring the annual U.S. contribution to a level 30 percent above what it was last year. That is a clear demonstration of support for economic development, tied to the idea that we want that support to create measurable improvements in peoples' lives.

A Better Sovereign Debt Restructuring Process

The second major reform initiative that I would like to discuss today is sovereign debt restructuring. It is part of our overall approach to emerging markets and the International Monetary Fund. The truth is that emerging markets have not been performing very well in the last four years. The flow of investments going through these markets has declined sharply. We would like more funds to go to the emerging markets and at lower interest rates. A more predictable sovereign debt restructuring mechanism can help achieve that goal.

An Emerging Markets/IMF Reform Strategy

Our sovereign debt restructuring initiatives are part of a multifaceted strategy toward emerging markets and the IMF. That strategy starts with a greater focus on crisis prevention, asking the IMF to look more closely at countries where economic trends appear unsustainable, giving more ownership to countries so that they can make the decisions before the crises get out of hand, and encouraging more transparency both on the part of countries and the IMF itself.

A related part of the strategy is to narrow the focus of the IMF—both its work and the conditions it imposes on borrowers. By narrowing the focus to core responsibilities—exchange rate regimes, monetary policy, fiscal policy, and the financial sector—the IMF will be able to concentrate more on preventing crises and give countries more ownership of policy.

Limiting official sector support to countries when they reach unsustainable debt situations is another key element of our emerging markets strategy. Large official sector support packages can distort incentives for countries and for investors. And, of course, such packages effectively bailout private sector investors who have already received high rates of return. I think it is becoming clearer that the official sector support in such cases is now being limited to a significant degree.

Keeping contagion low is another part of the overall strategy and is a major reason why official sector support can be limited in many cases. Clearly contagion was an important characteristic of the Asian crisis in the late 1990s. However, coming into the Bush Administration, we re-examined this contagion issue and saw that important trends were developing. People in the markets were paying more attention to economic fundamentals, differentiating between countries and events. Countries were being more transparent in their policies. Market research was more thorough. We commented favorably on this change, noting that contagion is not automatic. This communication with the markets was meant to build on and encourage the changes in the markets by emphasizing that policy decisions would not be based on unfounded claims of contagion. In fact, contagion has come down dramatically over the course of the last year. This is illustrated by the fact that the terrible economic situation in Argentina has not spread to other countries in the world, let alone the region.

A Decentralized Contract-Based Approach

But even if we are successful in all parts of the strategy mentioned above there is still something that is missing. Currently, when countries get close to a situation where debt is unsustainable, it is like approaching a black hole: no one knows exactly what will happen next. This leads to uncertainty on the part of public officials and market participants alike. It leads to pressures for IMF bailouts even in situations where debt becomes unsustainable.

A more predictable sovereign debt restructuring mechanism—a workout strategy—for countries that reach an unsustainable debt position would therefore be useful. Of course, ideally such a mechanism would never have to be used, but simply having it in place would greatly reduce uncertainty. There are several alternatives now being considered. We at the U.S. Treasury have been in close contact with people in the private sector—market participants, lawyers, and academics—as well as people at the IMF and other governments, especially finance ministries and central banks.

The most practical and promising proposal now on the table is a decentralized approach that creates debtor and creditor ownership of, and participation in, the process. This proposal would encourage borrowers and lenders to put certain clauses in their debt so that when a country needs to restructure, there is a more orderly process. For example, now in many bonds, 100 percent of bondholders must agree to restructure the financial terms of the bonds. This makes it possible for a small minority to stand in the way of a restructuring that the majority of bondholders feel is in their best interests. Majority action clauses in bonds would allow a specified majority to agree to restructuring terms. The decision of this majority would be binding on the minority. The clauses would also provide for the process and timing through which debtors and creditors come together

There are several possible ways to create incentives for countries to use such clauses, and encourage them to overcome the urge to cut a few basis points from their interest rate by avoiding such clauses. For example, the official sector could require that these clauses be utilized by any country with an IMF program. Or the IMF could make it a condition of exceptional access to its funds that countries utilize these clauses in their debt contracts. A range of ways to implement this proposal is possible. Of course, introducing new clauses is something one can only do for new bonds. Consequently, we are also exploring options that would facilitate more predictable workout processes under existing bond provisions.

Another possible approach to sovereign debt restructuring that is receiving wide attention is an IMF proposal, in which the IMF would step in and impose a stay on legal actions in certain circumstances. This proposal obviously calls for a larger role for the IMF than the more decentralized market-oriented approach described here. But even with the market-oriented approach there will be a role for the IMF in assessing sustainability and deciding on a new IMF program, at least for countries that choose to work with the IMF on a program.

As with the grants proposal, it will be necessary to work with other governments to come to a common agreement on a sovereign debt restructuring proposal. It will also be important to consult regularly with the private sector and with Congress. And as these discussions proceed we should never lose sight of the overall objective: to increase predictability and reduce uncertainty in the emerging markets so that more funds flow through them at lower interest rate spreads.

Concluding Remarks

In conclusion, there is one final point I would like to make about our reform efforts with the international financial institutions. A high priority with us is to make our own work with the institutions more effective and efficient. Currently, we are required to implement a very large number of mandates legislated by the Congress. These mandates including requirements for directed voting at the institutions, certifications, notifications, and reports. Our effectiveness in carrying our responsibilities with the IMF and the development banks could be strengthened if we are able to reduce and better rationalize these mandates. Some mandates go back 50 years. Some provisions overlap, or are inconsistent. We have 32 directed vote mandates, over 100 policy mandates, plus numerous reports, certifications, and notifications. We want the Congress to be fully informed, but numerous reporting requirements have increased the amount of time staff spends on these reports to levels that warrant serious concern. We would like to work with you to rationalize and focus our mandated requirements and reports.

Thank you very much. I would be pleased to answer any questions that you may have about the reform issues I discussed here, about our overall reform strategy, or about any other issues relating to the international financial institutions.